July 17, 2006

E-MAIL SUBMISSION ONLY

Federal Trade Commission
Office of the Secretary
Room H-135 (Annex W)
600 Pennsylvania Avenue NW
Washington, DC 20580

To the Commissioners of the Federal Trade Commission:

Re: Notice of Proposed Rulemaking
Business Opportunity Rule, 16 CFR Part 437

INTRODUCTION

I served as an Assistant Attorney General with the State of Wisconsin for 30 years, until retirement in 1997. During this period I litigated a number of pyramid cases – including extensive litigation against Amway[1] in the early 1980's and cases against Koscot Interplanetary, Bestline, and Holiday Magic in the early 1970's. These actions were pursued with the direct co-operation of Commission staff. My most recent pyramid case, against Fortune In Motion, was successfully concluded in 1997. I am currently a licensed attorney in the State of New York.

Because of my interest in the area of pyramid based business opportunity fraud, I have followed the Commission's activities and stayed in contact with others having similar interests, namely those associated with Pyramid Scheme Alert, which has filed its comments with the Commission through its president Robert Fitzpatrick.

In my dealings in this area, both before and after retirement, the single most disturbing element I have encountered in respect to pyramid schemes is the absence of a meaningful legal standard and enforcement posture on the part of the Federal Trade Commission. Since the Commission's Amway decision in 1979, the concept of a pyramid scheme has been confounded by the emergence of "Multi-Level Marketing"[2] which is portrayed as a legal business opportunity patterned after the Amway decision.

The confusion created by the Amway decision and the Commission's enforcement posture thereafter has left open the opportunity for many illegal pyramids, some of whom were eventually sued by the Commission, to take billions of dollars from persons who thought they were investing in a legitimate business opportunity. I have

[1] This litigation was based on income misrepresentations. Documented evidence, from tax returns, disclosed that Wisconsin Amway Direct Distributors (the top1%) had annual net incomes of minus $900.
[2] While many sales systems have multiple levels of distribution, the term has come to mean, in my opinion, a pyramid that uses the Amway 'rules' as a means of legalizing itself.

experienced first hand the economic and social damage caused by these pseudo-businesses.

My comments are directed to this issue. The promulgation of a business opportunity rule without dealing with this critical matter is truly to ignore the 800 lb. gorilla in the Commission's chambers.

I also wish to concur in comments submitted by Mr. Fitzpatrick and Jon Taylor of Pyramid Scheme Alert, Attorney Douglas Brooks, and author Eric Scheibeler.

I request a hearing under Commission procedures and am willing to testify as to the matters set forth below.

COMMENTS

The Commission asks in its reference to proposed section 437.1(c) what language it could use to make sure it 'captures' pyramid programs in the coverage of its Business Opportunity rule. It also references 'pyramid marketing' as a 'prevalent and persistent' problem.

The 'persistence' of the pyramid problem is now well established in the Commission's own files. Despite extended litigation in the 1970's, including the Koscot[3], Ger-Ro-Mar[4] and Amway[5] cases, recent activities document the continued and open prevalence of pyramid companies operating under the protective mantle called 'Multi-Level Marketing.' All recent pyramid litigation known to this writer involves marketing programs that claim they follow the 'rules' established in the Commission's 1979 Amway decision.

The fundamental problem, with economic consequences now well into the billions of dollars, is that the Commission has failed to put into clear terms the legal standards established in the Koscot and Ger-Ro-Mar cases and ratified in the 1996 Federal Appeals Court decision in Omnitrition[6]. This has enabled countless pyramids to operate under a definitional ambiguity that persists to this day.

The practical outcome of this serious omission is that a company can operate its pyramid company, claiming it is 'just like Amway', with virtual impunity. Since it is not possible for the Commission to pursue all such companies and document non-compliance with the Amway 'rules', many will run their predictable course, make millions for the originators and leave thousands in the dust thinking they failed in a legitimate 'business opportunity.' Others may eventually be brought to court, as happened in the

[3] Koscot Interplanetary, Inc., 86 F.T.C. 1106 (1975).
[4] Ger-Ro-Mar, Inc., 84 F.T.C. 95 (1974), rev'd on other grounds, 518 F.2d 33 (2d Cir. 1975)
[5] In re Amway Corp., 93 F.T.C. 618 (1979)
[6] Webster v. Omnitrition Int'l, Inc., 79 F.3d 776 (9th Cir. 1996), cert. denied, 117 S. Ct. 174, __ U.S. __ (1996).

Commission's Equinox case, but it is clear that it is impossible to undo in a court proceeding all the economic and social damage caused by such an effort.[7] Furthermore, all monies lost through investments in pyramids are directly diverted from legitimate business opportunities that could have been pursued.

At the present time, an attorney would be hard pressed to state the Commission's legal standard describing a pyramid operation. The Commission's web site provides little assistance. A 1998 speech delivered by FTC General Counsel Debra A. Valentine to the International Monetary Fund's Seminar On Current Legal Issues Affecting Central Banks states:

> Pyramid schemes now come in so many forms that they may be difficult to recognize immediately. However, they all share one overriding characteristic. They promise consumers or investors large profits based primarily on recruiting others to join their program, not based on profits from any real investment or real sale of goods to the public. Some schemes may purport to sell a product, but they often simply use the product to hide their pyramid structure. There are two tell-tale signs that a product is simply being used to disguise a pyramid scheme: inventory loading and a lack of retail sales. Inventory loading occurs when a company's incentive program forces recruits to buy more products than they could ever sell, often at inflated prices. If this occurs throughout the company's distribution system, the people at the top of the pyramid reap substantial profits, even though little or no product moves to market. The people at the bottom make excessive payments for inventory that simply accumulates in their basements. A lack of retail sales is also a red flag that a pyramid exists. Many pyramid schemes will claim that their product is selling like hot cakes. However, on closer examination, the sales occur only between people inside the pyramid structure or to new recruits joining the structure, not to consumers out in the general public.

Although the speech goes on to refer to the Koscot standard:

> The Commission found that Koscot operated an illegal "entrepreneurial chain" and articulated a definition of illegal pyramiding that our agency and the federal courts continue to rely on. The Commission found that pyramid schemes force participants to pay money in return for two things. First is "the right to sell a product", second is "the right to receive, in return for recruiting other participants into the program, rewards which are unrelated to sale of the product to ultimate users. (emphasis added)"

She then proceeded to discuss the Amway case:

> The Commission held that, although Amway had made false and misleading earnings claims when recruiting new distributors. The company's sales plan was not an illegal pyramid scheme. Amway differed in several ways from pyramid schemes that the

[7] FTC economist Peter Vander Nat in his 1997 declaration in the Commission' *Equinox* case stated: "I conservatively estimate that at least 90,000 distributors (out of a base of 100,0000 or more) have a per capita loss of $2,000 or more. Thus, I presently place aggregate harm at $180 million or more." Similarly, he estimates, conservatively, $125 million loss in the Commission's 2001 *Sky Biz* case (*FTC* v. *SkyBiz.com,* No. 01–CV–0396–EA (X) (N.D. Okla. 2001). The Commission's 2005 case against Trek Alliance et al (FTC v. Trek Alliance, Inc., No. 02–9270 (C.D. Cal. 2002) resulted in a restitution order in excess of $500,000.

> Commission had challenged. It did not charge an up-front "head hunting" or large investment fee from new recruits, nor did it promote "inventory loading" by requiring distributors to buy large volumes of nonreturnable inventory. Instead, Amway only required distributors to buy a relatively inexpensive sales kit. Moreover, Amway had three different policies to encourage distributors to actually sell the company's soaps, cleaners, and household products to real end users. First, Amway required distributors to buy back any unused and marketable products from their recruits upon request. Second, Amway required each distributor to sell at wholesale or retail at least 70 percent of its purchased inventory each month -- a policy known as the 70% rule. Finally, Amway required each sponsoring distributor to make at least one retail sale to each of 10 different customers each month, known as the 10 customer rule.

It is fair to state that it would be difficult to derive a meaningful legal standard from these statements, which appear to reflect the position of the FTC at the present time. The confounding references to 'head hunting, 'inventory loading' and exculpatory factors such as a 'buy-back' program, a '70% rule' and a 10 customer rule gave no clear idea of their relation to the Koscot standard or the legal presumptions that exist in cases for injunction and consumer redress.

I believe it is possible to elicit a standard from the Koscot decision, as interpreted in later cases such as Omnitrition, and view Amway as a factual conclusion based on the specific facts in that action. Commission staff has told me that the Amway case did not establish the Amway 'rules' but was a ruling on the specific facts of that case. Consistent with this, the Omnitrition case refers to the Koscot case as the source of the Commission's legal standard. As to Amway, the Omnitrition cour, at p. 784, stated:

> Omnitrition misreads Amway as holding that any "multi level marketing" program employing policies like Amway's is not a pyramid scheme as a matter of law. That was not the FTC's holding. The FTC held that Amway was not a pyramid scheme as a matter of fact because its policies were enforced and were effective in encouraging retail sales. This ruling does not help Omnitrition at the summary judgment stage.

In the recent Trek[8] case, defendants were charged with promoting a pyramid scheme, (Complaint pars 49, 67, 68), the case was resolved by consent order and the defendants prohibited from promoting a 'prohibited marketing program', defined as:

> 5. "Prohibited Marketing Program" means any marketing program or plan in which any participant pays money or valuable consideration to the company in return for which he receives the right to receive rewards, in return for recruiting other participants into the program, which are unrelated to the sale of products or services to persons who are not participants in the marketing program.

In Omnitrition, the court held, at pp. 781-82, the Koscot 'test' as controlling:

> The Federal Trade Commission has established a test for determining what constitutes a pyramid scheme. Such contrivances are characterized by the payment by participants of money to the company in return for which they receive (1) the right to sell a product *and* (2) the right to receive in return for recruiting other participants into the program rewards which are unrelated to sale of the product to

[8] FTC v. Trek Alliance, Inc., No. 02–9270 SJL (AJWx) (C.D. Cal. 2002);

> ultimate users. *Id.* (emphasis in original). The satisfaction of the second element of the *Koscot* test is the *sine qua non* of a pyramid scheme: "As is apparent, the presence of this second element, recruitment with rewards unrelated to product sales, is nothing more than an elaborate chain letter device in which individuals who pay a valuable consideration with the expectation of recouping it to some degree via recruitment are bound to be disappointed.". We adopt the *Koscot* standard here and hold that the operation of a pyramid scheme constitutes fraud for purposes of several federal antifraud statutes.

All marketing plans that engage in pyramid or multi-level marketing pay commissions to an upline distributor based on the wholesale purchase made by the distributor's recruit seeking to reach the same distributive position.[9] There is no relationship between this purchase and retail sales. As stated in Omnitrition, p. 782:

> This compensation is facially "unrelated to the sale of the product to ultimate users" because it is paid based on the suggested retail price of the amount ordered from Omnitrition, rather than based on actual sales to consumers.

Omnitrition, at p. 782, also dealt with the question whether the promoting company made some retail sales somehow, in itself, had relevance to the legitimacy of the marketing plan:

> Omnitrition cannot save itself simply by pointing to the fact that it makes some retail sales. *See In re Ger-Ro-Mar, Inc., 84 F.T.C. 95, 148-49 (1974)* (that some retail sales occur does not mitigate the unlawful nature of pyramid schemes), *rev'd on other grounds,*. 518 F.2d 33 (2d Cir.1975)

Commissioner Dixon, in his Koscot opinion went even further:

> As is apparent, the presence of this second element, recruitment with rewards unrelated to product sales, is nothing more than an elaborate chain letter device in which individuals who pay a valuable consideration with the expectation of recouping it to some degree via recruitment are bound to be disappointed. Cf. Twentieth Century Co. v. Quilling, 130 Wis. 318, 110 N.W. 173, 176 (1907). *Indeed, even where rewards are based upon sales to consumers, a scheme which represents indiscriminately to all comers that they can recoup their investments by virtue of the product sales of their recruits must end up disappointing those at the bottom who can find no recruits capable of making retail sales.*. . .
>
> What compels the categorical condemnation of entrepreneurial chains under Section 5 is, however, the inevitably deceptive representation (conveyed by their mere existence) that any individual can recoup his or her investment by means of inducing others to invest. *That these schemes so often do not allow recovery of investments by means of retail sales either merely points up that there is very little positive value to be lost by not allowing such schemes to get started in the first place.*
>
> (emphasis supplied)

[9] Other commissions may be paid for other reasons, but the payment structure related to a qualifying purchase made by a recruited participant is the only one under question.

Commissioner Dixon's condemnation of 'entrepreneurial chains' did not deal with 'buy back' and 10% and 70% rules, it focused directly on the chain element – i.e. paying for the right to recruit, for profit, others who seek the same rights, *ad infinitum.* While a functioning pyramid will likely not have many retail sales, given the financial rewards for recruiting and retail products embedded with multiple commission layers, the legal test does not rest on the absence of retail sales but on the elements of a chain.

The absence of a clear legal standard has, as the Commission's legal record supports in voluminous detail, created an inherent ambiguity that has enabled countless pyramid companies to begin and continue business risking only tardy redress in the future. Most of these companies have little if any fixed plant and can close their doors with little notice. The writer's last pyramid case against a company called, poetically, Fortune In Motion, took over $4 million from Wisconsin residents in a matter of months. Our forfeiture judgment against the company was of no value as all principals returned to Canada. This situation was prophetically foreseen by Commissioner Dixon in his Koscot opinion:

> A discussion of 'inherent' illegality and capacity to deceive may seem pointless given the more than 4000 pages of transcript detailing the actual deception and injury in which the Koscot plan resulted. *Nothing could be further from the truth. It is regrettably clear that responsible authorities, including this Commission, have acted far too slowly to protect consumers from the manipulations of respondents and others like them.* As this is written the corporate respondent, Koscot, is in Chapter XI reorganization proceedings, while the individual respondents plead poverty. The administrative law judge estimated that $44 million was taken from consumers (I.D. p. 59 [p. 1163, herein]), and no more than a fraction of that is presently accounted for. Whether more than a small fraction of the consumer loss will ever be recovered is open to serious doubt. These particular individual respondents may not, under the watchful eyes of federal authorities, repeat their misdeeds, but once has clearly been too much.
>
> We think that failure to act more promptly can be traced to the *previous inability of relevant authorities to obtain summary relief against the practices involved*. The necessity to prove that a marketing plan, manifestly deceptive on its face, has in fact resulted in injury to numerous consumers, is a lengthy process. *Only where the law condemns the mere institution of such a plan, without the necessity to demonstrate its consequences, is meaningful relief likely to be obtained. . . . . To require too large an evidentiary burden to condemn these schemes can only ensure that future generations of self-made commercial messiahs will dare to be great and dare anyone to stop them.*
>
> (emphasis supplied)

It is well time for the Commission to outlaw any company that falls within the Koscot test. If the company claims that their commissions related to new distributor purchases are based solely upon consummated retail sales then it must do as was done in Amway, prove to the satisfaction of the Commission that that is the case and that a pyramid structure does not exist. It should be the affirmative burden of any company facially operating a pyramid marketing operation, as defined by the Commission, to prove that its wholesale commissions in actual fact represent actual retail sales.

While ‘buy back’ provisions may have convinced the Amway ALJ that the company was protecting its distributors, twenty five years of Commission experience must have demonstrated that the cases where actual across-the-board protection was afforded by any such provision are non-existent. This writer directed a letter and ‘petition for compliance analysis’, set forth at the end of these comments, to Chairman Pitofsky in 2000 asking that some analysis of the Amway ‘rules’ be made as to their effectiveness both as to Amway and their value as any kind of predictor about the existence of a pyramid offering. I received no reply other than to indicate that the Commission was bringing cases against other pyramid companies.

As previously stated, requiring the Commission to prove that a company is not making retail sales, or honoring its ‘buy-back’ obligations, has placed an unnecessary and improvident burden on its enforcement efforts – in an area where abuses and economic damages have been abundantly proven over a twenty-five year span. As a start I would suggest the Commission poll its staff attorneys, present and past, as to whether they have ever encountered a pyramid style offering where the Amway ‘rules’ were actually enforced across the board and where the presence of these rules resulted in the absence of consumer injury in the manner anticipated by the Amway ALJ when he ruled.

One of the tragic aspects of a pyramid company holding forth as a ‘business opportunity’ (as opposed to the patent aspects of a ‘chain letter’ or lottery, known to be a gamble) is that new participants believe that they are entering a true ‘business’ environment where the rules of the retail marketplace apply. Thus, when they fail, they believe they could not pass the marketplace test. It is quite difficult, as my professional experience confirms, for these victims to recognize the reality of the situation and admit to themselves as well as to their friends and neighbors (many of whom they contacted to join the plan) that they were duped. This is borne out in the fact that very few victims complain to the authorities.

CONCLUSION

I recommend the following:

1. That an explicit definition of a pyramid offering be established by the Commission. The California Law PC327 is a respectable example. It states

> 327. Every person who contrives, prepares, sets up, proposes, or operates any endless chain is guilty of a public offense, and is punishable by imprisonment in the county jail not exceeding one year or in state prison for 16 months, two, or three years.
>
> As used in this section, an "endless chain" means any scheme for the disposal or distribution of property whereby a participant pays a valuable consideration for the chance to receive compensation for introducing one or more additional persons into participation in the scheme or for the chance to receive compensation when a person introduced by the participant introduces a new participant. Compensation, as used in this section, does not mean or include payment based upon sales made to persons

> who are not participants in the scheme and who are not purchasing in order to participate in the scheme.

Another clear prohibition of pyramids or 'chain distributor schemes' is the Wisconsin regulation Ch ATCP 122, Wis. Adm. Code, this writer participated in the drafting of this regulation in 1970, it has withstood all legal challenges.

> ATCP 122.02 Definitions. (1) "Chain distributor scheme" is a sales device whereby a person, upon a condition that the person make an investment, is granted a license or right to recruit for profit one or more additional persons who also are granted such license or right upon condition of making an investment and may further perpetuate the chain of persons who are granted such license or right upon such condition. A limitation as to the number of persons who may participate, or the presence of additional conditions affecting eligibility for the above license or right to recruit or the receipt of profits therefrom, does not change the identity of the scheme as a chain distributor scheme.

2. That any marketing plan which meets the prohibited standard be under a rebuttable presumption that the law has been violated. The company will be afforded, at trial or in pre-filing conferences, the ability to show that all sales related to its distributor qualifying wholesale purchase are in fact consummated prior retail sales and therefore not part of a pyramid structure intended to generate payments to a recruiting distributor.

3. That the Commission's rules enable a temporary injunction without any requirement of proof other than the elements stated in the definition.

Respectfully Submitted,

Bruce A. Craig, Esq.

LETTER TO FTC FEBRUARY 2000

February 25, 2000

Mr. Robert Pitofsky, Chairman
Federal Trade Commission
600 Pennsylvania Avenue, N.W.
Washington, D.C. 20580

Re: Petition for compliance analysis or enforcement review regarding In re Amway, 93 FTC 618 (1979), Docket 9023

Dear Chairman Pitofsky:

I served as an Assistant Attorney General for the State of Wisconsin for 30 years, until retirement in 1997. During this period I litigated a significant number of

pyramid cases – including extensive litigation against Amway(1) in the early 1980's and cases against Koscot Interplanetary, Bestline, and Holiday Magic in the early 1970's. These actions were pursued with the direct co-operation of Commission staff. My most recent pyramid case, against Fortune In Motion, was successfully concluded in 1997. I recite this history only in the hope that it will lend credence to what follows.

I direct this letter to you because you drafted the Commission's Amway opinion in 1979. The opinion appears to hold that (a) "a pyramid distribution scheme should now be condemned even without the demonstration of its economic consequences. The Commission has studied the effects of such 'entrepreneurial chains' and seen the damage they do and a per se rule should be used." [ALJ finding at par 107] and (b) that Amway would have been one of those "chains" but for(2) the existence, **and enforcement**, of the "buy back rule", the "70% rule" and the "10 customer" rule [93 F.T.C. 618, 716-17 (1979)].

These exculpatory rules have now become boilerplate in the hundreds of pyramid offerings that have surfaced since 1979. In my 1997 case, Fortune In Motion sought dismissal because it had incorporated the "Amway" rules into its marketing plan.(3) In Webster v. Omnitrition, 79F.3d 776, 782, 784 (9th Cir, 1996), the 9th Circuit reversed summary judgment in favor of the defendant, granted by the district court on the basis it used the "Amway" rules. "Our review of the record does not reveal sufficient evidence as a matter of law that Omnitrition's rules actually work."

Since investments in pyramid type offerings have resulted in billions of dollars in losses over the years, I believe it critical that the Commission, initially, determines whether in fact Amway currently enforces its rules to the extent that they produce the results the Commission anticipated in its decision.

The Commission may also want to consider, on a going forward basis, whether it is good policy to declare a practice per se illegal and then permit operation if certain exculpatory "rules" are incorporated in to the business plan. The attractive, but illegal, aspects of a pyramid proposal will continue to permeate a promoter's offering and recruiting efforts notwithstanding the theoretical dampening effect of the "rules." The economic motivation of a company utilizing a pyramid concept is in direct conflict with the exculpatory "rules" it promulgates.

There also exists the question, from an enforcement standpoint, whether these exculpatory factors can be effectively evaluated in time to prevent losses to the consuming public. When a pyramid, or "multi-level", company begins business operations there is no direct evidence if its "rules" are enforced or not. The time period between startup and detection is all some pyramids need. Fortune In Motion obtained over $4 million from Wisconsin residents during its short life and before we commenced litigation. The "buy back" rule was of no value since the company left the state and returned to its home offices in Canada. Does the enforcement agency bear the burden of proving that the "rules" are not enforced or is it an affirmative defense on the part of the pyramid company? Are all "multi-level" companies presumed to be pyramids until they prove their rules are effective in the manner contemplated by the Commission?

The contacts I have had with Amway, and other, distributors over the years indicates that the "rules" upon which the Commission based its decision are given, at best,

token recognition and are not broadly implemented or enforced. I have attached some unedited Amway distributor statements to simply give a flavor of their views on these issues. One such statement comes from a high level "Emerald" distributor. Determining the actual practices of Amway and its distributors in this respect would seem to be uniquely within the domain of the Commission. To this end, I will be asking some ex-distributor organizations to contact their members for comment to the Commission on this point, pro or con.

I decided to submit this petition for enforcement review because it seems that most distributors, after failing in what they thought was a valid business enterprise, are not motivated to complain or seek redress. They have, in many instances, been conditioned to believe that any failure was their fault. Many such distributors have lost life savings, stable jobs and their marriages. After having spent most of my career dealing with these companies from an enforcement standpoint, and witnessing the damage first-hand, I feel some obligation to these victims to make this effort on their behalf.

As indicated in Omnitrition, previously cited, and my Fortune In Motion case, the FTC Amway decision has created a good deal of uncertainty in respect to private and public legal efforts to deal with the abuses of pyramid plans. This will only increase with the onset of marketing over the Internet and the Globalization of this type of proposal.

I urge the Commission to make initial inquiry of Amway on the question of enforcement and enforceability of its rules. Documentation of compliance with the Commission's decision, and of the beneficial effects it anticipated, should be readily available from Amway and its distributors. I also urge the Commission to re-evaluate, in general, the efficacy of its "rules" in preventing the abuses it has documented in connection with pyramid marketing. The premise of "multi-level vs. pyramid" marketing may well represent a distinction without a difference.

If I can be of further assistance in any efforts of the Commission, or in clarifying matters stated herein, please feel free to contact me. I appreciate your taking the time to review this matter.

Sincerely,

Bruce A. Craig – Department of
Justice, State of Wisconsin
(Retired).
Of Counsel, Lawton & Cates, S.C.

c. Ms. Joan Z. Bernstein, Director, Bureau of Consumer Protection, FTC
James E. Doyle, Attorney General -- Wisconsin
Prof. Gerald J. Thain, University of Wisconsin Law School

1. This litigation was based on income misrepresentations. Documented evidence, from tax returns, disclosed that Wisconsin Amway Direct Distributors (the top1%) had annual net incomes of minus $900.

2. Some language in the opinion, pp. 716, 717, refers to the absence of inventory loading, "the purchase of a large amount of nonreturnable inventory" and the fact that an entry level Amway distributor makes no investment. However qualifying for the Direct distributor position does require mandatory monthly purchases, whether returnable or not depending on effective enforcement of the "buy-back" and other rules. The existence of the entry level distributor is not relevant to a pyramid analysis, the pyramid begins when the new distributor seeks to become a Direct. See Omnitrition 79 F.3d776, 782.

3. Wisconsin's pyramid rule, Ch. ATCP 122, Wis. Adm. Code does not contain the exculpatory "rules". It has been upheld by the Wisconsin Supreme Court.